AVOIDING THE DISCRETIONARY FUNCTION RULE IN THE MADOFF CASE

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I. INTRODUCTION

In a period when national economic turmoil floods newspaper headlines, when people are looking for jobs, and when money is scant Warren Buffet’s wisdom on faltering businesses and risky investment decisions holds true: “You only find out who’s swimming naked when the tide goes out.” Likewise, when bank accounts are fat and replenished as the need arises, no one asks questions about how the money got there. But, when the economy falters and bank accounts start rumbling from emptiness, the trivial fib that had gone unseen beneath the high tide of prosperity is exposed as a glaring and embarrassing fraud. Take the Madoff scandal, for example: Bernard L. Madoff (Madoff) was a well-established Wall Street investor who pled guilty to perpetrating one of the nation’s largest investment frauds that amassed $65 billion and caused thousands to lose their investments. As a result, the defrauded are pointing fingers, looking for answers, and most importantly, looking for money.

Typically, defrauded investors can seek recourse from the fraud perpetrator. However, in Ponzi scheme cases, this remedy is unavailable because most, if not all, of the investment money is gone—with bankruptcy the inevitable result. In turn, the investors become creditors of the fraudster’s bankruptcy estate (some fraudsters will have to disgorge portions of their money in the furtherance of that estate), and most will receive only a fraction of their original investment.

Unfortunately for the duped investors, incomplete restitution is inevitable, and, now chagrined, they search for anyone to blame and anyone to help. At some point, deceived investors approach the government; specifically, they point the finger at the regulatory body that purports to police the securities market and insulate the investment community from


3. For a discussion of the various remedies available to defrauded investors see infra Part IV.
the type of massive fraud that left them with burning heartache and empty pockets: the Securities and Exchange Commission (SEC). One of Madoff’s Ponzi victims has done precisely that. Phyllis Molchatsky and her attorney say she plans to sue the SEC in federal court after the agency declined a $1.7 million settlement offer made directly to the SEC. However, before addressing the question of whether the SEC is blameworthy, Molchatsky’s suit faces the enormous legal barrier of sovereign immunity, which shields the federal government from being sued by its citizens. In response to this quandary, this Comment proposes a theory to overcome sovereign immunity based on the Madoff scandal under the Federal Torts Claim Act (FTCA).

The FTCA is a body of legislation that allows the government, under certain instances and limited by certain exceptions, to be held liable for its agents’ negligent acts. One such exception is the discretionary function rule, whereby the government or one of its agencies—such as the SEC—will not be held liable. This rule permits government agents to not act or not fulfill their legislative duty if the act or duty at question is governed by the discretion of that agent or agency. This Comment proposes that such discretion should not be absolute. Instead, the broad and underlying purpose of any statutory scheme imposes a limit on the ability to exercise discretion. Specifically, where the SEC’s choice not to investigate conflicts with its broad goal of preventing fraud, it would not receive the protection of the discretionary function rule under the FTCA. In other words, this Comment argues that certain circumstances, such as the Madoff case, compel the SEC to investigate because failure to do so would conflict with its core and mandatory fraud prevention goal.

After such a bold proposal, a cautionary note is likely necessary. This Comment acknowledges that such a theory faces significant practical obstacles, such as the SEC’s limited financial resources to investigate and litigate. Because overcoming all those obstacles would exceed the limits of a single article, this Comment does not aim to address them all. Instead, it

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5. See, e.g., Sprecher v. Graber, 716 F.2d 968, 973 (C.A.N.Y. 1983) (explaining that the United States and federal agencies are immune from suit unless Congress has expressly waived sovereign immunity); Lipkin v. United States Sec. and Exch. Comm’n, 468 F. Supp. 2d 614, 616 (S.D.N.Y. 2006) (noting that absent compliance with the Federal Tort Claims Act’s requirements, the action is barred by sovereign immunity); see also 1 Administrative Law (MB) § 6A.02 (1998) [hereinafter Administrative Law].
7. See infra Part VI for a discussion about the FTCA.
8. Id.
merely aspires to show that SEC liability is not necessarily obstructed by the discretionary function rule under the FTCA and that the agency's liability is justified in certain circumstances.

Accordingly, this Comment will provide a comprehensive understanding of Ponzi schemes, the laws that provide insufficient compensation under a ratable distribution scheme for investors, and why liability on the SEC is proper in limited circumstances. Section II generally discusses Ponzi schemes. Section III discusses the Madoff scandal in detail. Section IV describes the different theories of recovery an investor may use to recover against a Ponzi operator and why these avenues of recovery are insufficient methods of recovery for defrauded investors. Section V transitions to provide a general understanding of the SEC, its purpose, and different functions. Section VI discusses sovereign immunity and the FTCA. Finally, Section VII concludes that SEC liability is appropriate in certain extraordinary circumstances.

II. PONZI SCHEMES DEFINED

Clichés abound when it comes to defining Ponzi schemes. The "rob-Peter-to-pay-Paul" concept is often used to describe Ponzi schemes. Moreover, the cautionary advice, "if it seems too good to be true, then it probably is," almost certainly applies to Ponzi schemes. Catchy headlines and pop culture aside, at their most basic level, Ponzi scheme operators collect money, or principal, from an initial set of investors, promising the investors a high return on their investment in a relatively short period of time, usually atypical of market norms. To avoid detailed questioning by


the investors, Ponzi operators "pitch" the scheme as highly intricate and complex. Consequently, the details of the proposed business operation or investment are not gravely important to the investor; a legitimate business venture, however, does not usually even exist. Once the operator collects the initial investment from the first set of investors, the operator must find a second set of investors to put money into the "operation." The Ponzi operator makes the same "high profit return" promise to the new set of investors. Unknown to the first and second set of investors, the operator plans to pay the promised returns to the first set of investors with the principal invested by the second set of investors, as opposed to profits earned by virtue of the underlying "pitched" business proposal. In Hirsh v. Arthur Andersen & Co., the Second Circuit Court of Appeals explained that "[t]he effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors." Ultimately, there are not enough new investors to generate funds to cover the initial investments of earlier investors, much less to pay the promised high returns. The result is financial insolvency for the "pitched" business, and financial ruin for many "pie-eyed" investors.

III. THE MADOFF PONZI SCHEME

The Madoff scheme was extraordinarily complex, but basically adhered to the typical components of a Ponzi scheme. On December 11, 2008, the SEC filed a complaint against Madoff and Bernard L. Madoff Investment Securities L.L.C. (BMIS). Madoff, a former Chairman of the board of directors of the NASDAQ stock market and a Wall Street investment advisor, was the sole proprietor and founder of BMIS. The proposed operations can range from stock options to renting office equipment. See John Clemency & Scott Goldberg, Ponzi Schemes and Claims Allowance, 19 A. BANKR. INST. L. REV. 14 (Nov. 2000).

12. See id.
13. See id.
14. See id.
15. See id.
16. See id.
18. Id. at 1088 n.3 (2d Cir. 1995); see also Karl A. Menninger, Scams and Cons, 74 AM. JUR. 3D Proof of Facts § 63, sec. 3 (2008) (discussing Ponzi schemes, frauds, scams, and cons).
19. See generally Clemency & Goldberg, supra note 12.
20. Id.
22. See id. at 2.
was a broker-dealer and investment advisor firm registered under the SEC which conducted investment advising services, market making services, and proprietary trading services. Madoff and BMIS were charged with investment adviser's fraud under Sections 206(1) and 206(2) of the Advisers Act of 1940, and fraudulent interstate transactions under Section 17(a) of the Securities Act of 1933. The allegations stated Madoff admitted to operating, by virtue of BMIS, a giant Ponzi scheme worth up to $50 billion. All transpired when authorities claimed Madoff grew concerned about clients' requests for redemptions totaling $7 billion. At that time, BMIS only had an estimated $200-300 million left, although it represented assets worth $17 billion. As in all Ponzi schemes, Madoff paid old investors with new investors' money, and as a result, the operation was insolvent. The operation could have continued had it not been for Madoff's confession to his senior employees (coincidentally his sons) at BMIS. Importantly, although the SEC is named as the plaintiff in the civil lawsuit against Madoff, the SEC was not credited for uncovering the fraud conducted by Madoff and BMIS; rather, it was his two sons who turned over the Ponzi man to the authorities.

One may ask, how exactly did Madoff sustain such a large operation for so long without being caught? For starters, Madoff was in the securities business since 1960 when he founded BMIS. Several years later in 1962, two accountants, Frank Avellino and Michael Bienes, raised money and promised investors a return between 13.5 and 20%; the funds were placed with and handled by Madoff. In 1971, BMIS became one of the first users of the NASDAQ Stock Market. In 1989, Madoff began managing funds for the Fairfield Greenwich Group (FGG). Madoff eventually managed

25. See 15 U.S.C. § 77q(a) (2006); see also Complaint, supra note 21, at 2.
27. Id. at 3.
28. Id. at 3-4.
29. Id. at 3.
31. Id. BMIS started by focusing on making markets in over-the-counter stocks and also handled investment accounts for clients. Id.
32. Id.
33. Id. NASDAQ Stock Market is an electronic system for dealers to quote over-the-market stocks. Id.
34. Id.
$7.5 billion for FGG. The next year in 1990, as an established investments guru, Madoff became a non-executive chairman of the NASDAQ Stock Market. In 1992, Avellino and Bienes, the two accountants who placed their funds with Madoff in 1962, were sued by the SEC claiming $441 million derived from selling unregistered securities. Madoff claimed he was not aware the funds he managed were illegal, and because the investor's money was accounted for, the authorities did not accuse Madoff of any wrongdoing. A few years later, in 2000 and 2001, fund managers and consultants began questioning the validity of Madoff's claimed generated profits. Moreover, along with the suspicion, the SEC was alerted and notified for investigation purposes, but no action was taken. Sometime in September of 2006, Madoff registered with the SEC as an investment adviser, and two years later in 2008 he claimed to the SEC "to have $17.1 billion in assets under management for as many as 25 clients." Finally, in December of 2008—in the midst of national economic turmoil—Madoff confessed that it was a giant Ponzi scheme.

Aside from being the largest Ponzi scheme to date, what is most surprising about the Madoff case is that the SEC had a chance to uncover the operation as early as 2000. Not only could the SEC have kept close tabs on Madoff because he was associated with Avellino and Bienes in the 1992 investigation, but the SEC also failed to examine Madoff in 2006 when he registered as an investment adviser. Traditionally, when an investment adviser registers with the Agency, the Office of Compliance, Inspections, and Examinations scrutinizes and examines the investor—in this case the SEC did not. Most strikingly though, is that they also had the

35. Ortega, supra note 30.
36. Id.
37. Id.
38. Id.
39. Id.
40. Id.
41. Ortega, supra note 30.
42. Id.
44. See Ortega, supra note 30.
detailed evidence presented by Harry Markopolos (Markopolos), a chartered financial analyst and certified fraud examiner. On Wednesday February 4, 2009, Markopolos testified before Congress and stated,

...[a]s early as May 2000, I provided evidence to the SEC’s Boston Regional Office that should have caused an investigation of Madoff. I re-submitted this evidence with additional support several times between 2000-2008, a period of nine years. Yet nothing was done. Because nothing was done, I became fearful for the safety of my family until the SEC finally acknowledged, after Madoff had been arrested, that it had received credible evidence of Madoff’s Ponzi Scheme several years earlier. There was an abject failure by the regulatory agencies we entrust as our watchdog.

Markopolos first began his investigation of Madoff in 1999 when one of his employer’s partners, working for Rampart Investment Management Company, asked him to match Madoff’s steady rate of returns so that the same could be offered to Rampart’s clients and in turn compete with Madoff. Markopolos soon discovered Madoff was representing to his clients that he operated a split-strike conversion strategy to generate steady returns on investments. Split-strike conversions are highly complex and can even cause confusion among market professionals.

Nonetheless, this was the “investment strategy” Madoff pitched to future investors, a complex operation that would not generate many questions; and as previously noted, a critical component to operating Ponzi schemes is avoiding questions by investors. As such, after calculating numbers for less than four hours, Markopolos mathematically proved that Madoff’s operation was nothing but a fraud. Upon his conclusion that Madoff’s operation was fraudulent, Markopolos drafted an eight page SEC Submission and arranged a meeting with attorney Grant Ward, the SEC’s Boston Regional Director of Enforcement. However, the SEC did not
react, as Markopolos simply put it in his testimony before Congress,

[given Mr. Ward’s position and my understanding of his mandate, I was shocked by his financial illiteracy and inability to understand any of the concepts presented in that submission. Mr. Manion and I compared notes after the meeting and neither of us believed that the Boston Region’s DOE had understood any of the information presented. Little did I know that over the next several years I would come to understand that financial illiteracy among the SEC’s securities lawyers was pretty much universal with few exceptions.  

Over the years that followed, Markopolos continued to track Madoff’s dealings and notify the SEC, but the Ponzi scheme was not revealed. As it stands today, Madoff’s defrauded investors who relied on the SEC to protect and uncover fraudsters like Madoff are certainly outraged and disgusted by his actions. What infuriates investors most are comments such as those made by former SEC Chairman Christopher Cox who stated that “the agency had credible and specific allegations about Mr. Madoff’s alleged fraud going back nine years.” Moreover, Cox acknowledged that he was “gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations.” These investors should demand answers and accountability for the years of overlooked red flags.

IV. REMEDIES FOR THE DEFRAUDED INVESTOR AND THEIR INEVITABLE INADEQUACY

In Re Bennett Funding Group illustrates a classic Ponzi operation that resulted in financially distressed investors seeking restitution through limited avenues of recovery, which were unable to make them whole. The Bennett Funding Group engaged in one of the larger Ponzi schemes recorded to date by leasing office equipment and selling various interests in those leases to investors. In the 1990s, the company sold over $2.13 billion in unregistered securities. The scheme defrauded over 12,000

55. Assessing the Madoff Ponzi Scheme, supra note 43, at 11-12 (testimony of Harry Markopolos).
56. See id. at 11-23.
58. Id.
59. Id.
60. In re Bennett Funding Group, 213 B.R. 227 (Bankr. N.D.N.Y. 1997).
61. Id. at 230; McDermott, supra note 11, at 157-58.
creditors, 200 banks, and other financial institutions and produced debts in excess of $1 billion.\footnote{In re Bennett Funding Group, 213 B.R. 227 (Bankr. N.D.N.Y. 1997).}

Over the course of several years, the bankruptcy trustee filed more than 10,000 lawsuits to recover payments for investors that had been defrauded and was able to recover nearly $100 million in alleged fraudulent transfers.\footnote{McDermott, supra note 11, at 158-59.} As of June 20, 2008, the bankruptcy trustee had distributed nearly $353 million to unsecured creditors.\footnote{See SEC, The Bennett Funding Group, Inc., http://www.sec.gov/divisions/enforce/claims/bennett.htm.} Despite the trustee’s relatively successful efforts, the recovery was miniscule in relation to the Ponzi operator’s debts which still exceeded $1 billion—much of which will never be repaid.

The Bennett case demonstrates a recurring theme in Ponzi cases: innocent investors lose the majority of their investment and are then left with inadequate avenues of recovery, in which restitution rarely amounts to the value of the investment.\footnote{See Trustee Files Bennett Liability Schedules, 29 Bankr. Ct. Dec. (LRP) No. 8, at A1 (Aug. 13, 1996).} Although the recovery in In Re Bennett was one of the more successful in Ponzi case history, the net worth of recovered assets barely reached twenty cents on the dollar, and thousands of creditors were left with unreplenished bank accounts.

Thus, regardless of the stage of the scheme, there is never enough money within its infrastructure to cover all of the principal investments. Exposure reveals this fact, separating the winners and losers. The winners are typically the early investors who received substantial, albeit phony, returns concocted primarily out of subsequent investors’ principal investment. The losers, obviously, are typically the late investors in the scheme, whose principal was lost and who never received any return.\footnote{See McDermott, supra note 11, at 158.}

Because the end result is insolvency, the Ponzi operator eventually becomes a debtor of the investors (now creditors) he defrauded.\footnote{Id.} Losing investors basically have three remedies available. The duped investors may individually sue the Ponzi operator under state fraud law, petition the court to assign a receiver to liquidate the assets of the operator’s estate, or ask the court to appoint a bankruptcy trustee to recover assets.\footnote{Id.; see also 11 U.S.C. §§ 704, 1104 (2006).} Practically speaking, however, the most viable option for defrauded investors dealing with an insolvent creditor—and the one primarily considered in this

\footnotesize{\begin{itemize}
  \item \footnote{In re Bennett Funding Group, 213 B.R. 227 (Bankr. N.D.N.Y. 1997).}
  \item \footnote{McDermott, supra note 11, at 158-59.}
  \item \footnote{See SEC, The Bennett Funding Group, Inc., http://www.sec.gov/divisions/enforce/claims/bennett.htm.}
  \item \footnote{See McDermott, supra note 11, at 158.}
  \item \footnote{Id.}
  \item \footnote{Id.; see also 11 U.S.C. §§ 704, 1104 (2006).}
\end{itemize}
Comment—is to appoint a bankruptcy trustee as the *Bennett* investors did.70 But as seen in *Bennett*, although the appointed bankruptcy trustee steps into the shoes of the swindled investors and asserts state law fraud claims (along with a host of recovery mechanisms under the Bankruptcy Code) in hopes of extracting as much money as possible from the creditor, his efforts fall short due to a lack of funds by the fraud perpetrator.71

A. THE FRAUDULENT TRANSFER

Some, but not nearly all, lost investments may be recovered by suing the Ponzi operator. In a typical Ponzi bankruptcy proceeding, the appointed bankruptcy trustee is obligated to maximize the estate’s value by “clawing”72 back any phony profits (defrauded principal) that earlier investors received from the scheme.73 If the trustee can prove the Ponzi operator fraudulently transferred phony profits to the early investors, the bankruptcy court can order those upper tier investors to disgorge any phony profits the Ponzi operator fraudulently distributed to them in the two years prior to the bankruptcy filing. Those profits are then placed in the bankruptcy estate.74

To recover these phony profits, a trustee may bring a claim under any state fraudulent transfer law; or the trustee may bring action under the Bankruptcy Code in combination with the appropriate state law claim under the UFTA or the UFCA.75 Within the fraudulent transfer claim, a trustee is

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70. Those who receive a return on their investment are usually the earlier set of investors; because the underlying operation was fraudulent, those returns are technically fraudulent transfers. *See id.* As far as procedure is concerned, a debtor can voluntarily submit himself to a bankruptcy court as dictated under Section 301 of the Bankruptcy Code. *See 11 U.S.C. § 301 (2006).* Conversely, a debtor can be forced into the confines of a bankruptcy court through an involuntary action pursuant to Section 303 of the Code. *See 11 U.S.C. § 303 (2006).*

71. McDermott, *supra* note 11, at 158.


The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition . . . .

*Id.*

75. *See McDermott, supra* note 11, at 160. “Section 544(b) of the Bankruptcy Code specifically allows a trustee to take advantage of state law: “The trustee may avoid any transfer of
able to pursue theories of actual or constructive fraud against the bankrupt Ponzi operator. 76 Under a constructive fraud claim the trustee must prove "that the transfers were made for less than a reasonable equivalent value,"77 and "that the transfers left the debtor with insufficient funds."78 This burden is rarely met, and even if it is, the trustee can only recover the phony profits the Ponzi operators distributed to early investor(s), rather than recovering any return on principal the investor received. 79 In most cases, this limit on recovery translates to an unsatisfactory sum for those who lost their entire principal to the Ponzi operator.

To prove actual fraud the trustee must show the transfers were made for less than a reasonable equivalent value, but the trustee must also prove "the transfer was made with the actual intent to hinder, delay or defraud the debtor’s creditors."80 This theory allows the trustee to recover all the funds transferred from the Ponzi operator to the investor, both principal and fictitious profits; therefore, a defrauded investor claim is typically more successful than one for constructive fraud.81 In cases of actual fraud, an investor may assert the good faith defense and avoid returning received

an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim . . . ." Id. at 160, n.16 (citing 11 U.S.C. § 544(b) (2006)).

76. McDermott, supra note 11, at 160.

77. Id. Courts generally hold that investors involved in Ponzi schemes do not receive reasonable equivalent value and fair consideration for the profit they receive from their initial investments. Id. at 164-170 (discussing other authorities holding that profits received from fraudulent transfers are not received for reasonable equivalent value or fair consideration and cannot be considered interest).

78. Id. at 160. The debtor is considered to have insufficient funds in connection with the fraudulent transfers when “the debtor was insolvent on the date that any transfer was made, or became insolvent as a result of the transfer,” or when “the debtor was engaged in business or transaction . . . for which its property remaining after the transfer was an unreasonably small capital,” or when “the debtor intended to incur . . . debts that would be beyond its ability to pay as such debts matured.” Id. at 170.

79. Id. at 160.

80. Id. Once a trustee proves that the debtor was operating a Ponzi scheme, a presumption of fraud arises and “the debtor’s actual intent to hinder, delay, or defraud his creditors is established as a matter of law.” Id. at 173-74. In Merrill v. Abbot, the court recognized that

One can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge to a substantial certainty constitutes intent in the eyes of the law, and a debtor’s knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.


81. See McDermott, supra note 11, at 160-61.
principal to the trustee, adding yet another impediment to adequate restitution.

When defending an actual fraud claim, an investor who received a fictitious profit on his principal investment can avoid a complete claim against both his profits and initial investment through the good faith defense. This defense allows an investor to retain some of the transferred funds. According to Bankruptcy Code § 548(c) the defense provides:

[A] transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

Under this language an investor must prove both “that he gave value for the transfers he received from the debtor,” and “that he received the transfers in good faith.” If the investor fails to prove a good faith defense, the trustee may recover “all amounts the investor received from the debtor.” Although relatively common, defeating the good faith defense at times represents only a marginal victory for a trustee seeking to accumulate value for the bankruptcy estate. In other instances, however, the good faith defense prevents funds from becoming part of the bankruptcy estate and deprives the later investors of sufficient recovery.

82. See McDermott, supra note 11, at 160-61.
83. Id. at 175.
84. Id.
86. McDermott, supra note 11, at 176.
87. Id. at 177. When the defense is raised, the burden of proof falls on the investor. The standard is that of a reasonable person, i.e., the investors may not claim they personally did not have any knowledge of the underlying fraudulent dealing; rather they must show that the facts surrounding the dealings would not put a reasonable person on notice of the debtor’s insolvency or fraud. Id. at 176-77. For a discussion of the factors a court weighs in determining good faith, see id. at 178-79.
88. Id. at 179-81; see also Jobin v. Cervenka (In re M&L Bus. Mach. Co., Inc.), 194 B.R. 496 (D. Colo. 1996) (finding lack of good faith on summary judgment due to the investor’s level of education, acceptance of post-dated checks in exchange for investments, and knowledge that no bank could provide the debtor with the amount of financing it needed); Hayes v. Palm Seedlings Partners (In re Agric. Research & Tech. Group, Inc.), 916 F.2d 528, 539-40 (9th Cir. 1990) (affirming summary judgment against the investor’s good faith defense when the value of the investment returned to the investor grossly exceeded the initial contribution by the investor, and when the investor expressed to the debtor that transfers would result in future investment).
89. See Merrill v. Abbott (In re Indep. Clearing House Co.), 77 B.R. 843, 862 n.29 (D. Utah 1987) (reversing summary judgment and finding the investor received the transfer in good faith
B. THE PREFERENTIAL TRANSFER

Another mechanism for recovery under a bankruptcy proceeding is recovery of the investor's money as a preference, governed through Section 547 of the Bankruptcy Code. Under this section of the code, a trustee can "avoid any transfer of an interest of a debtor in property within the ninety day period prior to the filing of the debtor's bankruptcy case." The transfers under the Code must have been made: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt; (3) while the debtor was insolvent; and (4) such "that [it] enables the creditor to receive more than he would have received if... the transfer had not been made and such creditor received payment of such debt," in accordance with the code.

The rule governing preferential transfers creates equality among the debtor's creditors, and it discourages the creditors from racing to dismember the debtor's estate in anticipation of bankruptcy. Furthermore, an advantage of a preference action is that the trustee may recover both principal investments as well as fictitious profits earned despite any objective or subjective good faith defense raised by the investor. Because the aforementioned defenses are available in fraudulent transfer cases but not in preference actions, the latter might lead to lofter return expectations for late investors. But other defenses can hinder the overall value of the bankruptcy estate. In addition, because Section 547 limits a preference due to false representations, the investor's lack of sophistication, and receipt of payments used by the debtor to mask suspicion of fraud).

92. For the investor to be a creditor he must be in privity with the Ponzi operator. See McDermott, supra note 11, at 182 n.108. Privity is created "when a Ponzi investor transfers to a debtor a principal investment." Id. at 182. Thus, because a claim is created through the principal investment on behalf of the creditor, the "claim constitutes an antecedent debt of the debtor to the investor." See id. at 183 (recognizing that fictitious profits and losses by bad faith investors cannot be recovered as preferences).
93. As a matter of law, if the operation of a Ponzi scheme is proven, then insolvency is automatically presumed; furthermore, the Code presumes insolvency within the ninety days prior to the petition date. See McDermott, supra note 11, at 183.
94. See 11 U.S.C. § 547(b)(5) (2006). To recover, the trustee must show that the investor recovered more than he would have recovered as an unsecured creditor under a liquidation of the debtor's estate. McDermott, supra note 11, at 184. Normally, this is easy to prove because in Ponzi cases the debtor has few assets (if any) remaining and creditors have lost most, if not all, of their principal investments. Id.
95. See Wootton v. Barge (In re Cohen), 875 F.2d 508, 509 (5th Cir. 1989).
96. See McDermott, supra note 11, at 182.
97. Common defenses asserted in preference actions include the new value defense and the ordinary course defense. See 11 U.S.C. § 547(c) (2006). "New value" constitutes new investments or funds transferred by the investor to the Ponzi operator but not any prior existing funds that are reinvested in the scheme. See id. § 547(a)(2). For a full explanation of "new
action to transfers made within ninety days, recoupment of transfers is confined only to the funds the debtor distributed three months prior to filing bankruptcy. In a giant Ponzi scheme, such as Madoff’s, which was ongoing for over a decade, recovery of funds distributed during the ninety days preceding bankruptcy will only be a small fraction of the overarching debt.

Despite the mechanism or theory of recovery pursued by a bankruptcy trustee, complete restitution of investors’ funds is never possible because of the ratable distribution scheme amongst creditors inherent to bankruptcy court. When the dust clears, all parties are trying to get their hands on as much money as possible without much regard for other parties; creditors become debtors and debtors become creditors. One court adequately described the struggles and frustrations between creditors and debtors in the following metaphor:

Understandably, creditors of bankrupt debtors often feel like restaurant patrons who not only hate the food, but think the portions are too small. To press the analogy, they also don’t like having to wait in line for a table, possibly being seated only to find out the kitchen has just closed. The bankruptcy court is a little like a soup kitchen, ladling out whatever is available in ratable portions to those standing in line; nonetheless, scarcity begets innovation in the hungry creditor’s quest to get a little more than the next fellow.

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value,” see McDermott, supra note 11, at 182. The ordinary course defense is provided in § 547(c)(2) as well. The ordinary course defense provides that “payments made to Ponzi investors cannot satisfy the requirement that payments must be ‘made according to ordinary business terms’ because ordinary businesses, among other things, do not pay fictitious profits.” See, e.g., Jobin v. McKay (In re M&L Bus. Mach. Co., Inc.), 84 F.3d 1330, 1339-40 (10th Cir. 1996); Sender v. Nancy Elizabeth R. Heggland Family Trust (In re Hedged-Inv. Asocs., Inc.), 48 F.3d 470, 475 (10th Cir. 1995); see also McDermott, supra note 11, at 185 n.125.


99. See Andrew Kull, Restitution in Bankruptcy: Reclamation and Constructive Trust, 72 AM. BANKR. L.J. 265, 281 (1998). Kull classifies the effect of a recipient’s bankruptcy as the following:

A successful restitution claim makes the claimant a creditor of the debtor, but the other creditors are already creditors. The bankruptcy estate is enlarged (or “swollen”) to the extent of unpaid obligation, but only in the manner that every other unpaid debt has contributed both to the estate and claimants against it. There is no identifiable transfer from the restitution claimant to the rival creditors; and restitution accordingly remains a first-order claim (against the debtor), rather than a second-order claim (against the creditors). In short, there is no reason why the surgeon’s claim should not be allowable in bankruptcy; but by establishing his claim in restitution, the surgeon (or any successful claimant in this category) merely becomes another creditor like others.

Id.

100. See XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.), 16 F.3d 1443, 1445 (6th Cir. 1994).
Unfortunately, the system produces victims, usually innocent parties who relied in good faith on the Ponzi operator's fraudulent antics. But unlike the hungry patrons at the soup kitchen, creditors of a bankruptcy estate in a Ponzi case do not have the option of soliciting the next most generous soup kitchen that is willing to offer a warm, albeit small, meal. As it stands now, creditors, or patrons of the soup kitchen—to continue the analogy—can only go after the initial wrongdoer, the Ponzi operator. If in fact, however, the Ponzi crook was simply a product of the system that enabled him to defraud the masses, shouldn't the hungry patrons seek recovery from the very system that made it all possible? In most tort apportionment schemes, if two parties are at fault and one is incapable of satisfying all his debts, the other would normally contribute to satisfy the debt or injury.

C. SECURITIES INVESTORS PROTECTION CORPORATION

The Securities Investors Protection Corporation (SIPC) provides another avenue of potential relief for defrauded investors if the Ponzi scheme involved securities as investment tools. The SIPC was created in 1970 through the Securities Investor Protection Act as a nonprofit membership corporation funded by its membership of securities broker-dealers.\(^1\) The "SIPC helps individuals whose money, stocks and other securities\(^2\) are stolen by a broker or put at risk when a brokerage fails for other reasons.\(^3\)

The organization fulfills the role of an insurer of the Ponzi operator's fraud. However, similar to the efficacy of bankruptcy proceedings, restrictions on the SIPC fund's disbursements and the reality of large Ponzi schemes often dictate an insufficient recovery. Ponzi investors who seek reimbursement from the SIPC are capped in what they can receive from the organization and face a labyrinth of conditions and strictures on actually getting money from the organization. Effectively, this avenue of recovery often does not suffice to make the investors whole.


102. This includes all non-negotiable stocks and bonds that are registered or about to be registered. SIPC Statute & Rules, supra note 101. "Among the investments that are ineligible for SIPC protection are commodity futures contracts and currency, as well as investment contracts . . . and fixed annuity contracts that are not registered with the U.S. Securities and Exchange Commission under the Securities Act of 1933." Securities Investor Protection Corporation, How SIPC Protects You, available at http://www.sipc.org/how/brochure.cfm [hereinafter How SIPC Protects You].

V. POWER, AUTHORITY, AND AUTONOMY: THE SEC'S ABILITY TO PREVENT WIDESPREAD FRAUD

Once the Ponzi victim has exhausted the SIPC option and the bankruptcy trustee has recovered all that he or she can through fraud claims, the Ponzi victim has thus pursued recovery from all blameworthy parties they are entitled to under current law. Typically, the victim's restitution at this point is far from complete and still highly unsatisfactory. What other source should or could a Ponzi victim have? Traditionally, the answer is none. There is, however, one more party relevant and related to many Ponzi schemes that could be tapped to provide restitution: the Securities and Exchange Commission.

Of course, this statement expects much from the SEC. Admittedly, it would be unjust and, more importantly, infeasible as matter of public policy to saddle the securities agency with the obligation to adequately restore every Ponzi victim now and in the future. This Comment does not operate under such delusion. Instead, it proposes a narrow exception to sovereign immunity that would make the SEC liable to defrauded investors in extraordinary and alarming cases of public fraud, where the SEC fails to faithfully carry out its core obligation in the face of egregious facts that ordinarily would mandate prompt investigation. In such a scenario, the SEC can fairly be considered a relevant and indirect party in a Ponzi scheme by virtue of its tacit and passive approval of the scheme.

This section explains in detail how the SEC can become tacitly involved in the operation of Ponzi schemes, and it defines a theory for Ponzi victims against the SEC. Furthermore, it attempts to overcome the impediments sovereign immunity presents for such a cause of action and to explain how the sovereign immunity exception stops short of transforming the SEC into a bail out organization for all disappointed investors.

The SEC commands a wide range of authority and responsibility in federal securities law. At its core, the SEC's original purpose is to

104. 1 THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 1.3 (5th ed. 2005) (1985). Federal securities law consists of seven statutes:
1) Securities Act of 1933 (regulating primarily public offerings of securities);
2) Securities Exchange Act of 1934 (extending "federal regulation to trading in securities which are already issued and outstanding");
3) Public Utility Holding Company Act of 1935 (integrating the financing and operations of the electric and gas public utility companies);
4) Trust Indenture Act of 1939 (applying to "public issues of debt securities in excess of $1,000,000");
5) Investment Company Act of 1940 (regulating "the composition of the management of investment companies, their capital structure, approval of their advisory contracts,
maintain "investor confidence in . . . capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing." To accomplish this end, Congress delegated four basic administrative powers to the SEC. These powers and responsibilities include rule-making, adjudication, investigation, and enforcement. Combined, the powers serve to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Primarily, however, the SEC is concerned with providing investors important market-related information, maintaining fair dealing among the players, and most importantly protecting against fraud.

Critical to its fraud protection goals are its investigatory and adjudicatory authority. The agency's investigatory power is vast and well-equipped to ferret out fraud in the securities market. Generally, the SEC can conduct independent investigations to determine if there has been a violation of securities law. These investigations and examinations may be launched through a variety of sources, such as utilizing its own staff. In addition, members of the public can submit complaints: market competitors, former employees, anonymous sources, the media, or other government agencies. Information sources include registration and changes in investment policy”;

6) Investment Advisors Act of 1940 (requiring registration and regulation of investment advisors); and
7) Securities Investor Act of 1970 (creating the Securities Investor Protection Corporation (SIPC)).

See DAVID L. RATNER & THOMAS L. HAZEN, SECURITIES REGULATION CASES AND MATERIALS 5-8 (5th ed. 1996) (1985). Ratner and Hazen explain that "[t]here is no federal 'common law' of securities, and any rights or liabilities must find their source in the statutes themselves." Id. at 11.

105. SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation [hereinafter The Investor's Advocate], http://www.sec.gov/about/whatwedo.shtml. The SEC serves to regulate two players in the market, the publicly traded companies and those trading and selling the securities. Id. Public companies must be truthful about their dealings, the securities they sell, and the risk associated with such securities. Id. Dealers, brokers, and exchanges have a duty to treat investors with fairness, honesty, and place the investor's priority first. Id.

106. HAZEN, supra note 105, § 1.4[1].

107. Id.

108. The Investor’s Advocate, supra note 105 (emphasis added).

109. Id. Some of the specific and more prevalent crimes against SEC policy are insider trading, accounting fraud, and providing inaccurate and deceitful information about securities and the companies that issue them. Id.

110. Id.


112. McLucas et al., supra note 111, at 627. As of 1988, an amendment was passed under the Securities Exchange Act of 1934 section 21(A)(e) allowing the Commission to award a bounty in
Discretionary Function Rule and Madoff statements, SEC computers, news stories, Standard & Poor's information, and price and volume history. Once the information is gathered, all relevant facts and legal theories are analyzed to develop a plan of investigation.

Investigations tend to begin as informal investigations governed by Section 5 of the Commission’s Informal and Other Procedures. The informal investigations, barring extraordinary circumstances, are generally non-public. If a party faces an informal investigation, the SEC requests voluntary information, documentation, and interviews and transcribed testimony. If the party is cooperative, an informal investigation may conclude the matter, assuming the substantive information is exculpatory. If the witness is non-cooperative or hostile, the agency may launch a formal investigation of that party or organization. Thus, the SEC has the power to conduct investigations before a violation has occurred. Even if the SEC does not believe that a violation “has occurred, is occurring or will occur,” it may investigate.

Given these vast investigatory powers, the Commission should be able to detect fraudulent activities such as egregious Ponzi schemes in the early stages through a normal course of diligent investigations. For example, if used appropriately, the Commission’s Section 8(e) powers would have allowed the agency to intercede in the Madoff scheme. The provision authorizes the commission to conduct an examination when it believes a stop trading order should be issued; it can then demand production of documents relevant to the examination, like balance sheets and income exchange for information regarding those who may be subject to civil penalties. See 15 U.S.C. §§ 77-78 (2006).

113. McLucas et al., supra note 111, at 632-33.
114. Id.
115. Id. at 628.
116. Id.
117. Id. The interviews are generally not under oath when part of an informal investigation; however, if the witness is asked to testify on the record, then they will be placed under oath. Id.
118. Id.
119. McLucas et al., supra note 111, at 628.
121. The SEC faces numerous procedural challenges when gathering information and conducting investigations in fraud related cases; however, while these obstacles may affect the SEC’s efforts, this Comment does not focus on those challenges but acknowledges that the SEC does not command unlimited force in its investigative efforts. For a list and explanation of the typical restrictions, see McLucas et al., supra note 111 (discussing challenges involving amongst others: the First Amendment, Fourth Amendment, Fifth Amendment, perjury, false statements, availability of transcripts, attorney-client privileges, the Freedom of Information Act, and the Privacy Acts of 1974 and 1978).
Between 2004 and 2005, after several complaints and allegations surfaced in reference to Madoff's corrupt practices, the SEC prepared a letter to the National Association of Securities Dealers (NASD) to demand production of documents related to Madoff's trading activity. However, the letter was never sent because "because it would have been too time-consuming to review the data they would have obtained"—this coming from the Commission responsible for guarding against fraud.\textsuperscript{123} The Inspector General's expert concluded that had such a request been made and fulfilled, the resulting information would have uncovered the Ponzi scheme.

Section 21(a)(1) authorizes further investigatory powers that could have been applied to the Madoff case. It authorizes the Commission to conduct investigations if a member of a securities organization is about to violate a provision of the Title. Thus, the Commission has authority to publish such findings; to investigate facts, conditions, or practices that may aid the enforcement of the provision; or to "serve as a basis for recommending further legislation" even if no violation will, has, or is occurring.\textsuperscript{124} In addition, Section 20(a) grants the Commission discretion to require a party to file a statement under oath regarding the subject matter it feels is of public interest and which it believes is being or is about to be violated.\textsuperscript{125}

This power was grossly underutilized in the Madoff case. The SEC received credible information from sources such as financial analysts and certified fraud examiners, like Harry Markopolos.\textsuperscript{126} Between June 1992 and December 2008, "the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading."\textsuperscript{127} In retrospect, any one of these complaints should have prompted the SEC to launch a thorough investigation into the matter, at least requiring Madoff to provide a statement under oath, even if Madoff's scheme turned out legitimate.\textsuperscript{128}

\textsuperscript{125}. Id.
\textsuperscript{126}. Id.
\textsuperscript{127}. See MADOFF INVESTIGATION, supra note 123, at 21.
\textsuperscript{128}. The SEC actually investigated Madoff during that time, but those investigations were not
Admittedly, none of these provisions contain the type of mandatory language that would have compelled the SEC to investigate. Instead, the provisions defer action to the judgment of the officers conducting, or not conducting, the investigations—even if fraudulent practices are known and legitimate. But, regardless of such insufficient legally compelling language, the underlying messages behind the provisions provide a security blanket for market participants. Moreover, the provisions illustrate that the SEC was highly capable of investigating in the face of repeated indications of fraud. Furthermore, its resources were not prohibitive. Because Ponzi investigations resemble typical broker-dealer investigations, the same staff that scrutinizes those types of investigations could also pursue Ponzi operators.

VI. GOVERNMENTAL LIABILITY IN TORT: AGENCIES AND SOVEREIGN IMMUNITY

As a federal entity, the SEC presumably acts zealously in the best interest of market investors; thus, any potential liability for damages stemming from lack of investigations, or possible conflicts of interests within the agency and private market participants, has historically been protected by the sovereign immunity doctrine. Consequently, like patrons at the neighborhood soup kitchen, investors seeking restitution from the Commission are left hungry. Hypothetically speaking, the SEC can openly admit from behind the safeguard of sovereign immunity that it decided not to investigate a case of egregious fraud whereby millions were damaged, without fear of liability. Thus, sovereign immunity presents a tremendous hurdle to financially distressed investors. Traditionally, the sovereign immunity defense bars liability; however, this Comment argues that such defense can be abridged in instances of egregious fraud through the body of legislation known as the Federal Torts Claims Act (FTCA).

A. BACKGROUND

As a government agency, the SEC enjoys sovereign immunity from civil damages. This premise evolved from “[t]he basic principle . . . that the sovereign cannot be sued without its consent.” Although the term “sovereign immunity” is not expressly written in the Constitution of the United States, the term is implied in the Eleventh Amendment, which

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129. See Administrative Law, supra note 5, § 6A.02.
130. Id.
131. The text of the Eleventh Amendment states, “The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.”
prohibits civil suits for damages against a state in federal court.\textsuperscript{132} The principle is not absolute; it can be defeated through consent amounting to an express waiver—a waiver that can only be exercised through legislation.\textsuperscript{133} Only Congress can decide when and under what conditions sovereign immunity will be waived, and even upon such waiver, a plaintiff may only bring suit if the cause of action specified is within the terms of the statutory waiver.\textsuperscript{134} As such, statutory waivers are usually construed in favor of the sovereign.\textsuperscript{135} Historically, sovereign immunity barred most tort claim actions for damages against the government and its affiliates, until the promulgation of the FTCA.\textsuperscript{136}

B. THE FEDERAL TORT CLAIMS ACT

Congress enacted the FTCA in 1946 for two essential reasons: first, to alleviate the slow, inequitable process of the private bill; and second, to allow relief for persons damaged by wrongs committed by government employees.\textsuperscript{137} With the promulgation of the FTCA, the federal government could be subject to suit for the wrongful or negligent acts of its employees.\textsuperscript{138} The United States is the named defendant (as opposed to the actual federal agency), and the attorney general reserves the power to settle the claims.\textsuperscript{139} The money awards from the claims are “payable by agency heads out of appropriations authorized by Congress.”\textsuperscript{140} The Act was amended several times within its first ten years.\textsuperscript{141} In

\begin{footnotesize}
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\item U.S. CONST. amend. XI.
\item 132. Id. See also Administrative Law, supra note 5, § 6A.02(1). For further commentary on sovereign immunity and governmental liability see David E. Engdahl, Immunity and Accountability for Positive Governmental Wrongs, 44 U. COLO. L. REV. 1 (1972); Louis L. Jaffe, Suits Against Governments and Officers: Sovereign Immunity, 77 HARV. L. REV. 1 (1963).
\item 133. Administrative Law, supra note 5, § 6A.02(1).
\item 134. Id. (stating that only Congress and not the Executive enjoys this power).
\item 135. Id.
\item 136. Id. § 6A.02(2). Prior to the FTCA’s enactment, from the period between 1887 and 1946, Congress enacted several statutes, by virtue of private bills, that allowed administrative heads to settle claims at a prescribed amount; either way, the process was slow, cumbersome, and faced the possibility of presidential veto. Id. See infra Part VI.B. for an in-depth analysis of the FTCA. See generally Cohens v. Virginia, 19 U.S. 264 (1821) (stating that the United States is immune from all suits); accord Kawananakoa v. Polybank, 205 U.S. 349, 353 (1907) (“[T]here can be no legal right as against the authority that makes the law on which the right depends.”).
\item 137. Administrative Law, supra note 5, § 6A.03(1).
\item 138. Id. § 6A.03(2). Notably, for purposes of liability and damages, the government employees must have acted within the scope of their employment. Id. See also 28 U.S.C. §§ 1346(b), 2401, 2671 (2006).
\item 139. Administrative Law, supra note 5, § 6A.03(2).
\item 140. Id. In its original form, the FTCA allowed agency heads to settle claims not exceeding $1,000 in those cases where no lawsuit had been filed. Id.
\item 141. Id. § 6A.03(3). These amendments include:
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1966, however, Congress passed an amendment requiring agencies, as a prerequisite to suit, to hear the administrative claims and to decide whether to settle claims under $25,000.\(^{142}\) Accordingly, the very agency against which the claim was filed assesses the merits of the claim and decides if it or its officers, or both, acted negligently.\(^{143}\) If the agency dismisses the claim, remedy in a district court is still available provided the suit was filed within six months from the notice of denial.\(^{144}\) In 1974, Congress passed an amendment to the Act holding the government accountable for torts committed by law enforcement or investigative officials.\(^{145}\) Furthermore, in 1988, another amendment passed making "suits against the United States the exclusive remedy for damages resulting from a negligent or wrongful act or omission of any employee of the government which was acting within the scope of office or employment."\(^{146}\) While the scope of sovereign immunity seemed to be narrowed by the FTCA, the doctrine still carries force because of the restrictions and exclusions implemented in the FTCA.

C. ESTABLISHING GOVERNMENT LIABILITY

Under 5 U.S.C. § 1346(b),\(^{147}\) recovery for loss of property is

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1) allowing the recovery of compensatory damages, even if the jurisdiction of the place only granted punitive damages;
2) providing for a two year statute of limitations;
3) excluding claims arising from the "Federal Land Bank, a federal intermediate credit bank, or a bank for cooperativeness";
4) increasing the authority of agencies to settle claims not exceeding $25,000; and
5) eliminating the requirement for agencies to file with Congress annual reports of all adjusted claims.

Administrative Law, *supra* note 5, § 6A.03(3).

142. *Id.* Settlement may only be made with the approval of the attorney general. *Id.*

143. See 28 U.S.C. § 2675(a) (2006). The statute provides that

An action shall not be instituted upon a claim against the United States for money damages for injury or loss of property or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, unless the claimant shall have first presented the claim to the appropriate Federal agency and his claim shall have been finally denied by the agency in writing and sent by certified or registered mail. The failure of an agency to make final disposition of a claim within six months after it is filed shall, at the option of the claimant any time thereafter, be deemed a final denial of the claim for purposes of this section.

*Id.*

144. Administrative Law, *supra* note 5, § 6A.03(3).

145. *Id.*

146. *Id.*


[s]ubject to the provisions of chapter 171 of this title . . . the district courts, together with the United States District Court for the District of the Canal Zone and the District Court of the Virgin Islands, shall have exclusive jurisdiction of civil actions on claims against the United States, for money damages, accruing on and after January 1, 1945, for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the
permitted; but, like any other claim, to establish liability on the United States, a claimant must prove that the cause of their injury was due to the negligence, omission, or wrongful conduct of a government employee. Furthermore, to prove a claim of negligence against the government, or for the purposes of this Comment, the SEC, a plaintiff must prove: "that the government owed an affirmative duty of reasonable care in the performance of some act or in the exercise of some conduct," a breach of that duty, that the breach was the proximate cause of the harm, and that there was actual loss or damage. Likewise the government or agency can raise any affirmative defense a private party would be able to raise.

If the negligence claim rests on the omission of an act, rather than the performance of an act, liability will be based on nonfeasance, taking into account the nature of the duty and the course of conduct. For a nonfeasance claim to survive, a relationship between the agency and the claimant must be shown establishing an affirmative duty to act. In the case of the SEC, its duty would be to investigate fraud. Notwithstanding the foregoing, however, a potential claimant seeking damages from the SEC will have to battle the discretionary function rule before the merits of its claim can be considered.


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148. See 28 U.S.C. § 2674 (2006). In pertinent part, Section 2674 provides that:

The United States shall be liable, respecting the provisions of this title relating to tort claims, in the same manner and to the same extent as a private individual under like circumstances, but shall not be liable for interest prior to judgment or for punitive damages.

If, however, in any case wherein death was caused, the law of the place where the act or omission complained of occurred provides, or has been construed to provide, for damages only punitive in nature, the United States shall be liable for actual or compensatory damages, measured by the pecuniary injuries resulting from such death to the persons respectively, for whose benefit the action was brought, in lieu thereof.

With respect to any claim under this chapter [28 USCS §§ 2671 et seq.], the United States shall be entitled to assert any defense based upon judicial or legislative immunity which otherwise would have been available to the employee of the United States whose act or omission gave rise to the claim, as well as any other defenses to which the United States is entitled.

Id.

149. Administrative Law, supra note 5, § 6A.04(1).

150. Id. § 6A.04(2)(a).

151. See § 2674; see also Administrative Law, supra note 5, § 6A.04(2)(a). Affirmative defenses in negligence cases usually consist of contributory negligence, imputed negligence, assumption of risk, or release. Id.

152. Administrative Law, supra note 5, § 6A.04(2)(b).

153. Id.
D. THE DISCRETIONARY FUNCTION RULE

Section 2680 of the FTCA further limits liability for claims involving omissions by government officials. One of these limitations involves the discretionary function rule. Section 2680 provides:

Any claim based upon an act or omission of an employee of the Government, exercising due care, in the execution of a statute or regulation, whether or not such statute or regulation be valid, or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.

Under the FTCA, if a government official is performing a discretionary function not mandated by the act, the government cannot be liable for any damages caused by that action or inaction. The clause essentially prevents the courts from interfering, controlling, revising, or supervising the performance of governmental entities; its main purpose is to prevent courts from implementing their own judgments or discretions in place of the official entrusted with that particular duty. Thus, if the omission involves an official exercising his own "judgment, choice, selection, [or] discretion," liability will be exculpable, regardless of whether "the official was acting negligently, wrongfully, or maliciously."

The first case to interpret the discretionary function rule was Dalehite v. United States. Dalehite involved a lack of notice given by the government regarding a dangerous shipment of fertilizer ammonium nitrate, and the Coast Guard's nonfeasance in policing the loading of a shipment. The Court rejected the claim of absolute liability on the government when engaging or handling dangerous activities with dangerous substances. Holding the United States was not liable for negligence, the Court, in regards to the discretionary function rule, articulated

. . . that the "discretionary function or duty" . . . includes . . . determinations made by executives or administrators in establishing

155. § 2680(a) (emphasis added).
156. Id. See also Administrative Law, supra note 5, § 6A.04(3)(a).
157. Id. § 6A.04(3)(a)(i).
158. Id.
160. Id. at 23-47. As a result of the negligence and omission by the government, a massive fire in the Texas City harbor caused the death of 560 people, 3,000 injuries, and millions of dollars worth of damage. Id. at 48 (Black, J. and Frankfurter, J., dissenting).
plans, specifications or schedules of operations. Where there is room for policy judgment and decision there is discretion. It necessarily follows that acts of subordinates in carrying out the operations of government in accordance with official directions cannot be actionable. If it were not so, the protection of § 2680(a) would fail . . .

While the Dalehite decision still governs the scope of the discretionary function rule, Indian Towing Co. v. United States modified certain aspects of the doctrine. Indian Towing involved the negligence of the Coast Guard in the operation of a lighthouse light on Chandeleur Island, Mississippi. As a result of the failure to properly operate the lighthouse, a tugboat and its cargo suffered damages of up to $62,659.70. The negligent acts alleged in the case included: failure to check the battery and sun relay system which operated the light; failure to make proper examinations of the connections; and failure to repair the light or give warning that the light was not operating. The Court distinguished the case from Dalehite on the grounds that Indian Towing involved "operational level" negligence, while Dalehite involved "planning level" negligence. Determining that the United States was not immune from liability and remanding the case to the trial court, the Court explained:

The Coast Guard need not undertake the lighthouse service. But once it exercised its discretion to operate a light on Chandeleur Island and engendered reliance on the guidance afforded by the light, it was obligated to use due care to make certain that the light was kept in good working order; and, if the light did become extinguished, then the Coast Guard was further obligated to use due care to discover this fact and to repair the light or give warning that it was not functioning. If the Coast Guard failed in its duty and damage was thereby caused to petitioners, the United States is liable under the Tort Claims Act.

In sum, Indian Towing stands for the proposition that, if the government assumes a duty it need not assume and thereby induces public reliance, liability may be imposed if negligence exists in the performance of the act or if there is an omission of an act related to the operation of that

163. Indian Towing Co. v. United States, 350 U.S. 61 (1955); see also Administrative Law, supra note 5, § 6A.04(3)(a)(iii).
164. Indian Towing, 350 U.S. at 62.
165. Id.
166. Id.
167. Id. at 64.
168. Id. at 69.
The most recent case addressing the discretionary function rule was the 1991 Supreme Court decision, \textit{United States v. Gaubert}. \footnote{See generally Indian Towing Co. v. United States, 350 U.S. 61, 69 (1955).} \textit{Gaubert} alters the aforementioned analysis to suggest that the discretionary function rule also applies to operational level decisions; the rule should not be solely limited to planning or policymaking situations because operational level decisions can also be based on public policy. \footnote{United States v. Gaubert, 499 U.S. 315 (1991).} The \textit{Gaubert} analysis implementing the discretionary function rule provides:

If a regulation mandates particular conduct, and the employee obeys the direction, the Government will be protected because the action will be deemed in furtherance of the policies which led to the promulgation of the regulation. If the employee violates the mandatory regulation, there will be no shelter from liability because there is no room for choice and the action will be contrary to policy. On the other hand, if a regulation allows the employee discretion, the very existence of the regulation creates a strong presumption that a discretionary act authorized by the regulation involves consideration of the same policies which led to the promulgation of the regulations. \footnote{Id. at 325.} As a result, the claims against the government’s negligent supervisory duties were dismissed under the discretionary function rule because the actions were in furtherance of public policy. \footnote{Id. at 319-20.} Furthermore, the Court in \textit{Gaubert} delineated how a plaintiff’s claim against the government would not be barred by the confines of the discretionary function exception. \footnote{Id. at 324.} The Court explicitly stated that the facts of the case must support that the action at issue was not one rooted in the policy of the regulatory command;

\footnote{Id. at 324.}

\footnote{Id.}

\footnote{Id. at 325.}
rather, the inquiry must focus not on the intent behind the agent’s decision to comply or not comply with the command, but on whether the actions taken by the agent conform with the policy measures for which the command was implemented.\textsuperscript{175}

Under \textit{Gaubert}, as applied to SEC liability for failing to investigate Ponzi situations, a plaintiff must show that the policy mandates agency officials to investigate. Furthermore, a court should not inquire as to the intent behind the decision the SEC agents had for not investigating a matter; instead they should inquire if the investigation of fraud in the market reflected a general policy concern for the implementation of regulatory statutes. As such, the next section of this Comment advocates that, although a discretionary function rule shelters the SEC from possible liability for failure to investigate, the rule does not apply in circumstances where exercise of their discretion would conflict with a core purpose of SEC legislation—prevention of fraud.

\section*{E. The Limit of SEC Discretion}

Although it is evident that the laws and regulations governing the SEC and other securities regulations are peppered with discretionary language,\textsuperscript{176} falling under the discretionary function rule exception, the main purpose behind the legislation is to protect investors and provide for safer markets while simultaneously promoting efficiency, competition, and capital formation.\textsuperscript{177} If it is to mean anything, this central purpose must impose some limit on an SEC investigator’s “rightful option” or discretion.\textsuperscript{178}

\begin{footnotesize}
176. See 15 U.S.C. § 78d-1(b) (2006) ("the Commission shall retain a discretionary right to review the action of any such division of the Commission"); 15 U.S.C. §§ 77h, 78u(a)(1) (2006) ("The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter"); 15 U.S.C. § 78u(d)(1) (2006) ("Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter . . . it may in its discretion bring an action in the proper district court of the United States"); 15 U.S.C. § 77t(a) (2006) ("Whenever it shall appear to the Commission . . . that . . . any rules . . . have been or are about to be violated, it may, in its discretion, either require or permit such person to file . . . a statement in writing . . . all the facts . . . it believes to be in the public interest to investigate.").
177. See 15 U.S.C. § 77b(b) (2006) ("Whenever . . . the Commission is . . . required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."). \textit{See also} 15 U.S.C. § 78b (2006) (discussing the necessity for regulation, perfecting the national market system, and safeguarding securities); 15 U.S.C. § 80a-1(a) (2006) ("It is declared that the policy and purposes of this subchapter, . . . are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.") (emphasis added).
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When circumstances such as the Madoff situation arise, the discretion granted in SEC investigatory provisions is not applicable. In the face of such glaring evidence of fraud, the SEC’s discretion to choose what it does and does not investigate is irrelevant. Instead, the broad fraud-prevention policy mandated by the legislative scheme is the relevant trigger. Thus, when evidence of fraud reaches a particular level, the SEC investigators should be compelled to act; otherwise, they would be in conflict with the SEC’s underlying legislative goal. In such egregious cases, the underlying fraud prevention policy should prevail over any operational level discretion. The degree of evidentiary support for fraud that would warrant this type of treatment is not the focus of this Comment; it suggests, however, that the Madoff case represents the minimal threshold at which operational level investigators should begin an inquiry as a non-discretionary matter.

This theory to overcome the discretionary function rule can be reconciled with Indian Towing and Gaubert to find the SEC liable for damages to defrauded investors for negligence and nonfeasance. Indian Towing implies that if the SEC assumed an unnecessary operational duty, which investors relied on, then it can be liable to those who are owed that duty. In such situation, the discretionary function rule will not apply to prevent a claim against the government. Gaubert alters that approach by providing that the discretionary function rule also applies to operational level duties, not only to situations that call for planning or policy making. In the case of the SEC and the statutes allowing officials to use their own discretion as to whether an investigation or enforcement should occur, the government would normally receive Gaubert protection from suit through the discretion granted to operational level investigators. However, nothing in Gaubert suggests that protection of this operational level discretion is absolute. The standard should be refined to recognize the limitation of an operational level employee's discretion; thus, his or her discretion cannot be exercised in conflict with a core purpose of the statute while still receiving the protection of the discretionary function rule under the FTCA. In the Madoff case, the choice not to investigate thoroughly, even in light of substantial evidence of fraud, would represent a deviation from the SEC’s obligation to prevent fraud.

Suits of this nature against the government would not over-compensate the victims. If victorious, recovery will be limited to an amount that is concrete and not speculative. The measuring point could begin when the SEC had hard credible evidence to pursue a lead. If at that time the lead is not pursued or investigated, an investor will measure damages as the amount of the investments lost—dating from when the SEC should have investigated to the time when the fraud surfaced. In the case of Madoff investors who kept investing money with Madoff under false hopes.
that Madoff had been audited or was within SEC compliance would measure their losses from the time Markopolos submitted his findings and credible evidence to the SEC up until December of 2008—when Madoff's fraud was uncovered. This recoverable amount assumes that an investor made the contribution in good faith and contributed new money or new value to the scheme. Even then the SEC would not be fully liable for the total amount. The damages against the SEC should be discounted from the amount received by the investor/creditor through the bankruptcy proceeding as well as that of the SIPC.

The implementation of these restrictions to recovery would dispel the notion that the government will serve as the deep-pocket defendant. Furthermore, the expectation that the SEC should fund recovery is not outstretched because in most circumstances, where an average investor is involved, the SEC is the more competent and adequate party to unravel underlying fraud. Certainly, investors should employ their own judgment and caution when engaging in transactions; however, investments should not be chilled by fear that regulators are not adequately addressing fraud in the market.

A plaintiff would have to prove his case by clear and convincing evidence. The balance may create less than stringent requirements on those providing the Agency leads, while at the same time discouraging whistleblowers whose information leads to a dead end. In other words, the SEC should still be protected through the discretionary function rule in situations where a lead was simply a suggestion as opposed to an affirmation. Facts and annotated accounts support such affirmation of evidence, which then lead to the suspicion of fraud. In contrast, single or sporadic complaints that have no veracity behind them would not abrogate the discretionary function rule if the Agency did not adequately and proactively address the complaint. But, when the lead is continuous, well supported, and involves a Wall Street investment mogul with numerous connections and affiliations, the SEC should not be able to hide behind the wrinkles of the discretionary function rule.

VII. CONCLUSION

Ponzi schemes are usually detected after investors and victims of the fraudulent business have suffered significant financial harm; and till this day, no proven method exists for preventing the schemes at their initial stages through preventive regulations. The fraud embedded in Ponzi schemes becomes visible once the scheme begins to suffer financially—by then monetary losses are inevitable. Regulators can clearly stop the scheme once they have discovered the players; however, if the players, like Madoff, could have been discovered sooner rather than later, significant financial
harm could have been avoided. In such a situation, later investors in the scheme may have an opportunity to recover most of their principal contributions. If the scheme continues upon alerted suspicion to the regulators—here the SEC—naturally more players will suffer a detriment.

In a situation where $65 billion has disappeared due to fraud, creditors of the bankruptcy estate will likely not receive complete compensation for their losses. While the law of fraudulent transfers, conveyances, and bankruptcy provide outlets for bankruptcy trustees to assert claims and impose liability on those who operate and contribute to Ponzi schemes, recovering a significant portion of principal investments in multi-million and billion dollar fraudulent ventures sometimes is impossible and unfounded.

Blame may lie in the hands of several perpetrators including the investors themselves for lack of caution and due diligence; however, when an overarching body is in place to regulate and prevent such criminal conduct, upon which investors ultimately rely, the SEC should be accountable and liable for those fraudulent investments it could have prevented after the commission was alerted that improper transactions were taking place.

While the burden of proof for imposing liability on the SEC should by no means be a walkover, liability should be narrowly tailored so as to defeat the discretionary function rule exception. By holding the SEC accountable and subject to civil liability, regulation of the securities market will ultimately improve and become more stringent. Imposing liability on the SEC will not only assure investors that there is a remedy, but will also sharpen the agency’s teeth that have dulled over the years.

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